MOTION FILED
NOV 15 1994

No. 94-18

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1994

ANTONIO MASTROBUONO, ET UX.,
Petitioners,

vs.

SHEARSON LEHMAN HUTTON, INC., ET AL.,
Respondents.

On Writ of Certiorari to the United States
Court of Appeals for the Seventh Circuit

MOTION AND BRIEF AMICUS CURIAE OF AMERICAN ASSOCIATION OF LIMITED PARTNERS IN SUPPORT OF PETITIONERS

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40 pp

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Pursuant to Rule 37.4 of the Rules of this Court, the AMERICAN ASSOCIATION OF LIMITED PARTNERS, through its counsel, respectfully moves this Court for permission to file a brief *amicus curiae* in this action. The proposed brief is printed with and follows this motion.

In support of this motion, applicant states the following:

1. This brief is proffered to the Court in order to bring relevant matter to its attention that has not been brought to its attention by the parties.

2. Applicant is an independent, not-for-profit national organization based in Washington, D.C. It was founded in 1990, and has approximately 3500 members. It seeks to act as an advocate on behalf of limited partners and other investors to ensure fairness in financial investments, and to provide investors with educational knowledge and materials. Applicant has testified before Congress, and has been widely quoted in major national financial publications.

3. Applicant's interest in this case stems from its overall mission of investor protection and promotion of principles of fairness in the investment marketplace.

4. Counsel for applicant has previously appeared before this Court as *amicus curiae*, by motion, in Plaut v. Spendthrift Farm, Inc., No. 93-1121.

5. In order to ensure this brief conforms with Rule 37.1 of this Court, counsel has reviewed the opinion of the Court of Appeals, and has spoken with petitioners' counsel as to the matters raised below. Based thereon, applicant believes this brief fully comports with Rule 37.1. For the reasons set forth in the brief, applicant also believes the legal issues discussed are properly before the Court, and are necessary to resolve in order to decide the cause.

6. Applicant files this motion because not all parties have consented to the filing of this brief. Petitioners have consented, while respondents have declined to consent.

For the foregoing reasons, applicant respectfully asks that its motion to file a brief *amicus curiae* be granted.

I declare under penalty of perjury of the laws of the United States that the facts set forth herein are true and accurate to the best of my personal knowledge.

Dated this 14th day of November, 1994.

Respectfully submitted,

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INTEREST OF AMICUS CURIAE

The American Association of Limited Partners (AALP) is an independent, not-for-profit national organization based in Washington, D.C. It was founded in 1990, and has approximately 3500 members. It seeks to act as an advocate on behalf of limited partners and other investors to ensure fairness in financial investments, and to provide investors with educational knowledge and materials.

AALP is committed to protecting investor rights where such rights are being abused or threatened. AALP has testified before Congress, and has been widely quoted in major national financial publications.

AALP believes this case is one in which investor rights are in fact being threatened, and which creates a great potential for abuse of those rights. As a result, it seeks to bring before this Court matters that relate directly to its mission of fairness in the investment marketplace. In AALP's opinion, this case is much more than what the Court of Appeal perceived it as, a mere choice-of-law dispute. It instead involves far greater issues of investor protection that need to be addressed, based on strong legal as well as policy reasons. AALP appreciates the opportunity to present its views to this Court.

SUMMARY OF ARGUMENT

First. The NASD is bound by section 19(g)(1) of the Securities Exchange Act of 1934 to comply with and enforce Rule 21(f)(4) of its Rules of Fair Practice. As a result, NASD arbitrators are bound under section 19(g)(1) to refuse to give effect to any private agreement purporting to limit their ability to make any award. Any provision seeking to bind the

NASD to waive such compliance with section 19(g)(1), such as the one in this case, is rendered void by Section 29 of the Exchange Act. This result especially follows from the premises of the federal securities laws and this Court's decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), which include integrity of self-regulatory organization (SRO) rules and nonwaiver of substantive rights in arbitration. Those premises must be maintained fully intact, lest the carefully balanced system of laws which ensures the fairness of SRO arbitrations to the public investor be seriously undermined.

Second. Petitioners had the right to demand arbitration directly under the NASD Rules, without any reference to the arbitration agreement; as a result, the arbitration agreement is irrelevant and moot, and should not be the basis of any enforced waiver of rights. Furthermore, there is no language in the Customer's Agreement specifically stating that petitioners were waiving any rights or even mentioning those rights, and no contractual waiver of rights should be enforced unless it is clear a party knows it is making a waiver. That is especially true here, as the purported waiver is in a preprinted agreement between parties of unequal bargaining power, there is no language indicating a waiver of any sort, and there was no consideration for the waiver because petitioners had exactly the same right to arbitration with or without the arbitration agreement. Finally, enforcement of a waiver implied solely from interpretation of caselaw in a jurisdiction that is the subject of a choice-of-law clause would have atrocious practical consequences for millions of people, and especially investors, who must engage in commercial transactions in which a choice-of-law clause is imposed on them.

ARGUMENT

I. The Attempted Punitive Damages Prohibition Is Rendered Void By Exchange Act Sections 19(g) And 29(a), Since It Purports To Prevent The NASD From Complying With And Enforcing Its Own Rules

This case is much more than a mere "difference over the proper interpretation of the choice of law clause." Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 709 (7th Cir. 1994). It is governed firstly by the federal securities laws. Section 29(a) of the Exchange Act operates to void any provision seeking to prevent the NASD from enforcing and complying with its own rules, such as the one at issue here.

A. Applicability Of Exchange Act Sections 19(g) And 29(a)

Section 19(g)(1) of the Exchange Act, 15 U.S.C. § 78s(g)(1), requires that a registered securities association "shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and . . . absent reasonable justification or excuse enforce compliance . . . with such provisions . . . by its members and persons associated with its members . . . ." (Emphasis added.) The NASD, the body that conducted the arbitration at issue in this case, is a registered securities association. 15 U.S.C. § 78o-3; Sorrell v. SEC, 679 F.2d 1323, 1325 (9th Cir. 1982); Todd & Co. v. SEC, 557 F.2d 1008, 1011-12 (3d Cir. 1977).

The provisions of section 19(g)(1) are obligatory. A self-regulatory organization shall comply with its own rules, and shall enforce compliance with its rules by its members and associated persons. As the Seventh Circuit has

recognized, section 19(g)(1) "expressly requires an exchange to comply with, and enforce compliance by its members with, its own rules. . . . [I]t is clear that Congress intended . . . Sec. 19(g)(1) to impose an affirmative legal duty upon registered exchanges." Spicer v. Chicago Board of Options Exchange, Inc., 977 F.2d 255, 259 (7th Cir. 1992).

The Court of Appeal's decision is explicitly based on its interpretation of Art. III, Sec. 21(f)(4) of the NASD Rules of Fair Practice (hereinafter "Rule 21(f)(4)"), and its opinion that Rule 21(f)(4) did not prevail over New York law to the contrary. Mastrobuono, 20 F.3d at 717-18. Rule 21(f)(4) provides that "[n]o agreement shall include any condition which . . . limits the ability of the arbitrators to make any award" (emphasis added). Mastrobuono, 20 F.3d at 718.

This is a rule of a self-regulatory organization. Accordingly, under section 19(g)(1), the NASD must comply with it, and enforce compliance with it by members and associated persons. The NASD has an "affirmative legal duty" to do so. Therefore, the NASD is obligated to enforce and comply with Rule 21(f)(4) and its prohibition against arbitration agreements which purport to limit its arbitrators' power to render any award.

Because Exchange Act section 19(g)(1) requires that the NASD must enforce compliance with all of its rules, including Rule 21(f)(4), the contrapositive is true as well. Exchange Act section 19(g)(1) prohibits the NASD from not enforcing compliance with Rule 21(f)(4), just as it prohibits the NASD from not enforcing compliance with any of its other rules. It also prohibits the NASD from failing to comply with Rule 21(f)(4). Section 19(g)(1) thus prohibits the NASD from treating an agreement purporting to limit arbitrators'

power to render any award—one in direct violation of Rule 21(f)(4)—as fully valid, proper and enforceable.

Put differently, under section 19(g)(1), the NASD must always retain full power to take whatever action it deems necessary, against a private agreement that contravenes Rule 21(f)(4). Furthermore, because the NASD must also comply with its own rules, it must ensure that no agreement operates to limit arbitrators' power in the prohibited manner—exactly what Rule 21(f)(4) specifies. Its arbitrators can, and are duty-bound to, refuse to give effect to such a private agreement purporting to nullify their power.

Section 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a), provides (emphasis added): "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be **void**." In turn, Exchange Act section 3(a)(9), 15 U.S.C. § 78c(a)(9), defines "person" broadly as including a natural person, company, government, or political subdivision, agency, or instrumentality of government. See also In re Washington Public Power Supply System Securities Litigation, 623 F.Supp. 1466, 1479-80 (W.D. Wash. 1985).

The National Association of Securities Dealers, Inc. is a corporation, see NASD Certificate of Incorporation, NASD Manual ¶ 1003, and it is an entity carrying on a commercial enterprise. In other words, it is a "company." See, e.g., Black's Law Dictionary 281 (6th ed. 1990). It is thus a "person" under the Exchange Act.

Thus, under Exchange Act section 29(a)(1), any provision binding a person such as the NASD to waive

compliance with any provision of the Exchange Act (Chapter 2B of Title 15 of the U.S. Code) is void. Section 19(g)(1), the statute requiring the NASD to comply with and enforce its own rules, is such a provision.

What section 29(a)(1) renders void is exactly what respondents' interpretation of the customer's agreement does. By entering into a private agreement that purports to prohibit the NASD from complying with and enforcing Rule 21(f)(4), respondents also seek to bind the NASD to waive compliance with Exchange Act section 19(g)(1).

As a result, even if the "New York law" provision of the customer's agreement meant what respondents want it to, it would still be **void** by virtue of section 29(a)(1), to the extent it attempts to prohibit the NASD from complying with and enforcing Rule 21(f)(4). It is therefore void to the extent it purports to prohibit arbitrators from making any award under that Rule. Respondents claim, and the Seventh Circuit held, that the New York choice-of-law provision in the customer agreement "trumps" Rule of Fair Practice 21(f)(4). Mastrobuono, 20 F.3d at 717-18. But Exchange Act section 29(a)(1) "overtrumps" the choice-of-law provision on the punitive damages issue.[1]

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[1] The one/three year statute of limitations in section 29 is not relevant to this case. First, it only applies to actions regarding violations of rules or regulations prescribed under 15 U.S.C. § 78o(c)(1) or 78o(c)(2), which are not at issue in this dispute over whether punitive damages may be awarded. Second, it applies only to actions maintained in reliance on section 29, and is thus by its terms not applicable to solely defensive measures to avoid another party's attempt to enforce a contract in violation of the Exchange Act, which is what petitioners are engaging in here.

Simply put, respondents cannot use a private contractual provision as a means of prohibiting the NASD from complying with and enforcing its own rules. Had Shearson's preprinted customer's agreement been more direct and explicitly said, "This agreement requires the NASD not to comply with or enforce Rule 21(f)(4) and thereby prohibits it from awarding punitive damages in any NASD arbitration," the applicability of sections 19(g)(1) and 29(a)(1) would be obvious. It should be no less so when respondents have tried to accomplish exactly the same thing through a more roundabout method.

B. Further Considerations Under The Federal Securities Laws

That section 29 applies to void the purported punitive damages waiver is not merely fortuitous. It is, rather, part of a central purpose of the federal securities laws, which is to protect the investing public and to ensure that the self-regulatory organizations actively effectuate that vital purpose.

The beneficiary of the 1934 legislation was intended to be the public investor, and the Exchange Act was enacted "'for the purpose of bringing safety to the general public in the field of investment and finance. . . . It is in the light of the interests of the general public that the bill was drawn.'" Lank v. New York Stock Exchange, 548 F.2d 61, 65 (2d Cir. 1977) (quoting H.R. Rep. 1383, 73d Cong., 2d Sess. 15 (1934)).

The federal securities laws leave the implementation of that important purpose to the securities self-regulatory organizations, subject always to the oversight of the SEC. "The primary purpose of the Exchange Act was to protect customers of the stock exchanges, that is, public investors.

One method of effectuating this was to impose on the exchanges a statutory duty 'to protect investors by regulating [the exchanges'] members. . . .' Lank v. New York Stock Exchange, 548 F.2d at 64 (quoting Note, Exchange Liability for Net Capital Enforcement, 73 Colum. L. Rev. 1262, 1264).

As long as the SROs are able to fulfill this vital obligation, the SEC's oversight power need not come into play. Conversely, if the power of an SRO to protect investors is impaired, the federal laws will operate to eliminate the impairment. "[T]he Senate Committee Report stressed that 'the initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain within the exchanges themselves. It is only where they fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so.'" Silver v. New York Stock Exchange, 373 U.S. 341, 352 (1963) (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934)).

The NASD, like the other major SROs, has set up an elaborate system of rules to ensure that broker-customer disputes can be settled simply and fairly through arbitration, without any sacrifice of the customer's substantive rights. In addition, the NASD is still an organization of securities firms, and it is crucial that there be both fairness and a perception of fairness in the conduct of arbitrations that involve a member firm. The existence of SRO rules and procedures, with the SEC's statutory duty of approval to ensure their adequacy, are precisely why this Court held in McMahon that arbitration procedures amply ensure fairness to public customers. Id., 482 U.S. at pp. 233-234.

Thus, the current system of arbitration procedures reflects a careful balance between the desire for simplified

dispute resolution, and a need to ensure that the goals of investor protection embodied in our federal securities laws are fulfilled. That system is set in place by both the SEC's approval of the NASD's rules of arbitration, under Exchange Act section 19(b)(1) [15 U.S.C. § 78s(b)(1)], and the NASD's statutory charge under Exchange Act section 19(g) to enforce and comply with those rules.

Respondents seek to undo this carefully balanced SEC-approved system. Were respondents' arguments to prevail, a member firm could override any SRO rule it wanted to, as long as it could get the other party to "agree" to it (even if the "agreement" were nothing more than a boilerplate preprinted customer's agreement, see infra Part II(B)(1)). That defeats the entire purpose and structure of the self-regulatory mechanism, by which the SRO enforces its rules against members who seek to act contrary thereto. It also defeats the overall Congressional paradigm. The integrity of the SRO rules is a central part of the whole structure of the federal securities laws, and it neither can nor should be changeable at the instance of a member firm, especially by means of a preprinted customer's agreement.

It is also worth stepping back to see how different this case is from Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), a case in which similar issues arose in a much different factual context. For example, in McMahon, this Court held that section 29(a) did not forbid waiver of section 27 of the Exchange Act [15 U.S.C. § 78aa] because "Sec. 27 does not impose any statutory duties." McMahon, 482 U.S. at 228. By contrast here, section 19(g)(1) does

impose statutory duties, and any attempt to override it is subject to the prohibitions of section 29(a).[2]

In addition, McMahon rested on the principle that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute [, and thus] the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights." Id., 482 U.S. at 229-230, 232. But that is exactly wrong in this case, because under respondents' view, petitioners are barred from remedies in arbitration that they would have in a court of law. Under respondents' view petitioners by agreeing to arbitrate their state-law claim have in fact foregone substantive rights.

If nothing else, this Court should be chary of enforcing the purported waiver of substantive rights in the manner sought by respondents, for the reason that the fundamental premises of McMahon do not exist in this case.

While arguments based on Exchange Act sections 19 and 29 have apparently not been raised until now, that should not matter. Since the choice-of-law provision is void to the extent it purports to prohibit punitive damages, a federal court has no jurisdiction to give it any effect; something that is void is a nullity and does not exist in contemplation of the law. See also 9 U.S.C. § 2. Absence of subject matter

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[2] In addition, McMahon generally relied on the SEC's "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs, id., 482 U.S. at 233, a presumption which in turn rested on the SEC's statutory power to approve all SRO rules and rule changes. Respondents, however, seek to effect a *de facto* nullification of this SEC power, by what amounts to a private cancellation of Rule 21(f)(4) for purposes of this case—and many more like it—without the approval of the SEC that is statutorily required for an SRO rule change.

jurisdiction to enforce this void provision may be raised at any time, even for the first time to this Court. Clark v. Paul Gray, Inc., 306 U.S. 583, 588 (1939); Dunton v. County of Suffolk, 729 F.2d 903, 910 (2d Cir.), modified on other grounds, 748 F.2d 69 (2d Cir. 1984). Subject matter jurisdiction to enforce a void provision is also lacking because of the absence of a substantial federal question. Levering & Garrigues v. Morrin, 289 U.S. 103, 105 (1933); Dunton v. County of Suffolk, 729 F.2d at 910.

Furthermore, the issue of whether the attempted waiver of section 19(g) is void is a "question antecedent to [those decided by the Court of Appeals and argued below] and ultimately dispositive of the present dispute." Arcadia, Ohio v. Ohio Power Co., 498 U.S. 73, 77 (1990). Since it goes to the very existence of the contractual provision in question, it must be resolved first, and the resolution should control the outcome of this case. That is especially so because the Federal Arbitration Act does not provide for enforcement of arbitration agreements where there are grounds at law or equity for the revocation of the agreement.

The facts of this case are little different from a hypothetical customer agreement such as, "X Firm shall not be bound by any rule of a self-regulatory organization, except at its election." Such a hypothetical agreement would be contrary to the system of self-regulation on which our securities laws are based, and would be ineffective to the extent it sought to prohibit an SRO from enforcing and complying with its rules. The current case may entail a much lesser invasion of the role of an SRO than such a hypothetical customer agreement, but the relevant legal principles are the same. Thus, at least in the context of the regulated securities industry, the Seventh Circuit errs in its view that "short of authorizing trial by battle or, more doubtfully, by a panel of

three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes . . . ." Baravati v. Josephthal, Lyon & Ross, 28 F.3d at 709.

In AALP's view, the federal securities laws play a vital role in our economy, especially in today's climate, where investment is often a necessity and not merely a luxury. See infra, Part II(B)(2). The securities laws should be interpreted liberally to achieve their important purposes, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), and as an Act of Congress, they should prevail over contrary language in a private agreement. Any ambiguity or uncertainty as to whether a private agreement is governed by the federal securities laws should be interpreted in favor of the remedial policies of investor protection that underlie those laws, as well as the policies of regulatory oversight and SRO enforcement.

Consequently, the judgment should be reversed, with directions to remand to the District Court to reinstate the award of punitive damages.

II. Petitioners' Arbitration Was Governed By The NASD Rules, Not The Customer's Agreement; Even If It Had Been Governed By The Customer's Agreement, No Purported "Waiver" Of Substantive Rights Should Be Enforced When There Is No Waiver Language In The Agreement

Two other threshold issues that have not yet been addressed are: Does the arbitration agreement in the preprinted customer's agreement govern this case at all; and if it does, what have the parties agreed to in that agreement? Those issues are also central to and controlling in this case.

A. The Customer's Agreement Is Inapposite To This Case

This entire dispute presupposes that petitioners' arbitration was governed by the customer's agreement. However, that is not necessarily so.

Petitioners were not required to invoke the customer's agreement in order to file their complaint in arbitration. Section 12(a) of the NASD Code of Arbitration Procedure requires disputes arising in connection with the business of a member firm to be arbitrated either based on an arbitration agreement, **or** "upon demand of the customer." Section 12(a) of the Code of Arbitration Procedure is very simple; if a customer demands arbitration under the NASD Rules, (s)he gets it. There is no requirement that a customer must invoke a written arbitration agreement.[3]

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[3] The Code of Arbitration Procedure is prescribed and adopted pursuant to Article VII, Section 1(a)(3) of the NASD By-Laws. NASD Code of Arbitration Procedure, § 1.

If petitioners elected arbitration under the "demand of the customer" provision of section 12(a), there should be no New York law clause to invoke, because the customer agreement would be irrelevant to the arbitration. It is not true that submission to New York law is a "general condition" on the petitioners' right to invoke arbitration, compare Mastrobuono, 20 F.3d at 717. Rather, petitioners may invoke arbitration entirely under the NASD Rules.[4]

Based on this, no choice-of-law provision in a customer's agreement can operate to limit a customer's rights that would otherwise be available under the rules of the NASD. The customer can simply choose arbitration under the "demand of the customer" provision in section 12(a), and bypass the customer's agreement.

As an alternative analysis, the customer's agreement itself says that the arbitration shall be conducted "in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc." Section 12(a) of the Code of Arbitration Procedure is one such rule. Moreover, section 42 of the Code of Arbitration Procedure states: "This Code shall be deemed a part of and incorporated by reference in every agreement to arbitrate under the rules of the National Association of Securities Dealers, Inc. including a duly executed Submission Agreement."

As a result, the customer's agreement itself—with the Code of Arbitration Procedure incorporated by reference—invokes an NASD rule that permits the customer

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[4] Similar provisions permitting arbitration at the behest of a public customer exist under the rules of major stock exchanges. See, e.g., New York Stock Exchange, Constitution Art. XI and Rule 600; American Stock Exchange, Constitution Art. VIII, Sec. 1.

to demand arbitration directly, without any reference to or need for the New York choice-of-law provision in that agreement. Using this analysis, the customer's agreement effectively bypasses its own choice-of-law provision by going straight to the NASD Rules, including the "demand of the customer" provision of Section 12(a).

The customer's agreement says the agreement is to be governed by New York law. It does not say the arbitration must be. If the petitioners elected arbitration directly under the "demand of the customer" provision and not the customer's agreement, there would be no cause for New York law to apply. In that event, if state law applied, the remedy would ordinarily be governed by either the law of the forum state or the state having the most significant contacts with the controversy, which in either case is Illinois. Frankel v. Allied Mills, Inc., 369 Ill. 578, 582, 17 N.E.2d 570, 572 (1938) (*lex fori*); Purcell & Wardrope Chartered v. Hertz Corp., 175 Ill.App.3d 1069, 530 N.E.2d 994 (1988) (most significant contacts); see Mastrobuono, 20 F.3d at 715. Nothing in Illinois law prohibits punitive damages in arbitration.

This alone should be dispositive, since a federal court has no jurisdiction to enforce a purported "waiver" under the Federal Arbitration Act, when the parties' arbitration agreement is inapposite to their dispute. If there were any doubt, it should be resolved against respondents, since it was their preprinted customer's agreement that petitioners signed, and all doubts in interpreting a contract should be resolved against the party who drafted it. United States v. Seckinger, 397 U.S. 203, 210 (1970); SOS Oil Corp. v. Norstar Bank of Long Island, 76 N.Y.2d 561, 568, 561 N.Y.S.2d 887, 563 N.E.2d 258, 261 (1990). Since the customer's agreement is irrelevant to this arbitration, there should be no occasion to

impose a punitive damages waiver that can only be argued to emanate from the customer's agreement.

Therefore, the purported waiver of punitive damages in the customer's agreement should not be enforced, because there is no appropriate legal basis on which to enforce it.

B. Federal Courts Should Not Enforce Purported "Waivers" Of Substantive Rights In Arbitration Agreements That Are Based On Inference, And Not The Plain Language Of The Arbitration Agreement

1. There Is Nothing To Suggest Petitioners Intended To Agree To Waive The Right To Punitive Damages, And No Proper Basis For Enforcing Such An Unintended "Waiver"

Even if this Court were to hold that the Customer's Agreement governs here, the question still remains: What have the parties agreed to?

It is noteworthy that the customer's agreement does not say in plain language, "Punitive damages shall not be awarded in any arbitration proceeding." Instead, respondents seek to import this substantial limitation on petitioners' rights through the "back door" of a choice-of-law provision that is claimed to refer to the entire body of New York caselaw, including one case therein which respondents claim "waives" contrary provisions of the rules of the arbitral tribunals specified in the customer's agreement.

A fundamental tenet of interpreting any contract is that a court seeks to effectuate the intent of the parties. Standard Oil Co. of New Jersey v. United States, 340 U.S. 54, 57 (1950); Chesapeake & Ohio Canal Co. v. Hill, 82 U.S.

(15 Wall.) 94, 99-100 (1873). The same is true for an arbitration agreement enforced under federal law, Litton Financial Printing Div. v. NLRB, 501 U.S. 190, 210 (1991); Gateway Coal Co. v. United Mine Workers, 414 U.S. 368, 382 (1974)—an obvious corollary of the fact that an arbitration agreement is a form of contract. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985). It is true that the parties' intentions are construed in favor of arbitrability, id., but that does not mean they are construed in favor of the waiver of substantive rights.

That a contract is to be interpreted to effectuate the intent of the parties is the law of New York as well. "In the construction of written contracts it is the duty of the court, as near as may be, to place itself in the situation of the parties, and from a consideration of the surrounding circumstances, the occasion and apparent object of the parties, to determine the meaning and intent of the language employed. Indeed, the great object, and practically the only foundation of rules for the construction of contracts, is to arrive at the intention of the parties." Maloney v. Iroquois Brewing Co., 173 N.Y. 303, 310, 66 N.E. 19, 20 (1903).

Here, respondents would have to argue that petitioners intended through such obscure means as these to waive all rights to punitive damages, at the time they signed the customer's agreement. That argument should flunk any test of common sense. One would think that if anything, petitioners intended what the agreement said they were doing—agreeing to arbitration "in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc." Nothing therein would have precluded punitive damages.

Respondents apparently argue that petitioners are charged with having looked past the language of the contract

and even past the language of New York statutes, researched New York caselaw, determined what New York caselaw actually stood for, and thereby made a determination that the right to otherwise available punitive damages was really an illusion. This is not how a contract is formed, and parties cannot be held to waive substantive rights in this manner.

Rather, in order for there to be any waiver by contract, the language of the contract must make it clear that the contracting parties have intended a waiver. This follows directly from the principle that a contract should be interpreted to effectuate the intent of the parties. One need not adopt a "knowing and intelligent" standard for constitutional waiver, Carnley v. Cochran, 369 U.S. 506, 515-516 (1962); but even in a civil contractual context, there must be some element of intentionality to a waiver, and a waiver is still an intentional relinquishment or abandonment of a known right or privilege. Johnson v. Zerbst, 304 U.S. 458, 464 (1938); accord Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1387 (11th Cir. 1988), and cases cited; J. Alexander Securities, Inc v. Mendez, 17 Cal.App.4th 1083, 1093-1094, 21 Cal.Rptr.2d 826, 832 (1993), cert. denied, __ U.S. ___, 114 S.Ct. 2182 (U.S. June 6, 1994).

New York law is particularly strict in this area. Waiver is not only an intentional relinquishment or abandonment of a known right, but there can only be a waiver when there is "both knowledge of [the right's] existence and an intentional to relinquish it." United Commodities-Greece v. Fidelity Int'l Bank, 64 N.Y.2d 449, 457, 489 N.Y.S.2d 31, 34, 478 N.E.2d 172, 175 (1985). Such a waiver is not lightly presumed. Gilbert Frank Corp. v. Federal Ins. Co., 70 N.Y.2d 966, 968, 525 N.Y.S.2d 793, 520 N.E.2d 512, 514 (1988).

These principles militate strongly against any waiver. Since the contract did not say petitioners were waiving their right to punitive damages, and there is nothing anywhere else in the record to suggest they had any intention of relinquishing that right, no waiver should be inferred.

The circumstances of this case, involving a preprinted brokerage house agreement, particularly call out for refusing to enforce a waiver of substantive rights not spelled out in the agreement. In Fuentes v. Shevin, 407 U.S. 67 (1972), this Court refused to give effect to a contractual waiver of the right to a prior hearing for reasons fully applicable here. Most notably, "the contractual language relied upon [did] not, on its face, even amount to a waiver." Id. at 95. And here as in Fuentes, "There was no bargaining over contractual terms between the parties who, in any event, were far from equal in bargaining power. The purported waiver provision was a printed part of a form [brokerage] contract and a necessary condition of the [brokerage]. The [respondents have] made no showing whatever that the [petitioners] were actually aware or made aware of the significance of the [provision] now relied upon as a waiver . . . ." Id. See also infra, p. 27.

The purported waiver of punitive damages here may not involve rights as constitutionally profound as the basic right to notice and a hearing in Fuentes. But the right to punitive damages when provided for by law is a significant and substantial state-law right, and the federal courts are being called upon to deny petitioners any such state-law right. Even if some aspects of Fuentes have been subsequently narrowed by this Court, there is nothing to suggest the analysis above is based on anything other than good law.

But under any circumstances, and Fuentes notwithstanding, "A waiver of a stipulation in an agreement

must, to be effectual, not only be made intentionally, but with knowledge of the circumstances." Bennecke v. Insurance Co., 105 U.S. (15 Otto) 355, 359 (1882); Utley v. Donaldson, 94 U.S. (4 Otto) 29, 49 (1877). There is no such thing as a "stealth waiver." None can be inferred from language which on its face would not suggest to a reasonable contracting party that it is waiving anything.

Furthermore, the mere fact that this issue has split the Circuits (and at least one state court) and is now before this Court is ample evidence that the language of the contract does not clearly and obviously constitute a waiver of the right to punitive damages. If it is not even clear to the courts that this language constitutes a waiver of rights, how could the Mastrobuonos be expected to know this? When they signed their customer's agreement, they were trying to make investments, not argue a case before the United States Supreme Court. They manifested no intent at all, let alone a clear intent, to adopt such an uncertain "waiver."[5]

These are issues that should be reached by this Court. If there is no legal basis for holding petitioners intended to waive their right to punitive damages by signing Shearson's customer agreement, then there is no legal basis for holding that the contractual agreement to arbitrate incorporates such a waiver. A federal court has subject matter jurisdiction to

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[5] Furthermore, a jurisdiction's caselaw is not always completely clear; sometimes, not even a jurisdiction's courts can agree on what its caselaw is. While courts can clarify their law in later decisions, the same standard is not true for contracting parties. Rather, the obligations of a contract are supposed to be definite and certain at the time of the contract. A "contract" that requires the parties to interpret caselaw to figure out what its provisions are can hardly be viewed as a contract, since caselaw can generally be interpreted in more than one way.

enforce an arbitration agreement under 9 U.S.C. § 2—to the extent there *is* an agreement, and only to that extent.

The issue of whether there *is* a contract for the waiver of punitive damages is not only jurisdictional, it is also purely one of law, appropriate for this Court's consideration. Indeed, since this Court would have no jurisdiction to sustain respondents' position if there were no binding contract to waive punitive damages the first place, this too is a "question antecedent to [those decided by the Court of Appeals and argued below] and ultimately dispositive of the present dispute." Arcadia, Ohio v. Ohio Power Co., 498 U.S. at 77.

2. Strong Policy Reasons Militate Against Respondents' Proffered "Waiver By Choice Of Foreign Law Provision"

Beyond these legal considerations, the result sought by respondents would have awful repercussions throughout our illegal system, extending to the conduct of everyday affairs by millions of people in this country.

It is one thing for sophisticated parties voluntarily to hire attorneys to negotiate the best possible contract. It is quite another to say that an ordinary citizen or small business considering a proposed preprinted contract must hire an attorney to do caselaw research to determine what the terms of the proposed contract are. To give the contract the meaning respondents seek would be to hold that the Mastrobuonos had such an obligation.

Indeed, to give the contract the meaning respondents seek could potentially force any ordinary citizen, faced with a preprinted contract such as this one, to hire an attorney if (s)he wants to know the very terms of the contract (s)he is

signing. If a person sees a choice-of-law provision in any contract—be it an auto loan, a mortgage, a tuition assistance agreement, or the like—the person must obtain legal assistance to scour another state's caselaw to figure out what is in the contract. (We are not talking about only selected portions of caselaw; since one can never know where the "hidden traps" are, apparently the only way to discover them is to look everywhere.) In fact, a person contemplating such an contract might be required not only to hire an attorney, but to hire an attorney from another jurisdiction.

This is an absolutely atrocious result. It is a potentially staggering burden on everyday commerce by ordinary citizens and small businesses. Those who do not wish to shoulder the burden are put at risk of "waivers" they would never have reason to anticipate. The result could even operate as a trap for the unwary by encouraging larger businesses to put hidden "choice-of-law" waivers into preprinted agreements, intentionally.

An enormous amount of modern commerce is handled through preprinted agreements required by large businesses. There is no way an average person or small business can hire an attorney at every turn to try to figure out what the terms of each one of those agreements are supposed to be. And as a result, people will operate in complete uncertainty of what they are agreeing to, every time they sign an agreement with a choice-of-law provision.

AALP is especially disturbed by the possibility of such a result because of its grave ramifications for investors.

Investment through a brokerage firm, or another entity that might insist on a preprinted arbitration clause, is no longer just a luxury for the rich. It is an absolute necessity for

millions of people of much lesser means, including people who are just trying to save some money for retirement through a mutual fund, or seeking other means for growth of modest assets—perhaps merely to keep up with inflation. Arbitration agreements are everywhere, and a person may have absolutely no choice but to sign one if (s)he wants to invest any amount of money anywhere, beyond putting it in the bank at 2-3 percent. "The average investor would be hard put to find a brokerage that would accept his/her business without a prior arbitration agreement." In re Arbitration Between Dreyfus Service Corp. and Kent, 183 A.D.2d 446, 448, 584 N.Y.S.2d 483, 485 (1992) (Asch, J., concurring).[6]

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[6] This was the very reason why one judge of the Appellate Division, in a recent case, suggested that the rule of Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 386 N.Y.S.2d 831, 353 N.E.2d 793 (1976) might be ripe for reexamination in light of changing times and circumstances:

> The four person majority in Garrity (supra, at 359) wrote, in pertinent part:
>
> "Parties to arbitration agree to the substitution of a private tribunal for purposes of deciding their disputes without the expense, delay and rigidities of traditional courts. If arbitrators were allowed to impose punitive damages, the usefulness of arbitration would be destroyed. It would become a trap for the unwary given the eminently desirable freedom from judicial overview of law and facts. It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncontrollable. It would lead to a Shylock principle of doing business without a Portia-like escape from the vise of a logic foreign to arbitration law.

(continued...)

[6](...continued)

"In imposing penal sanctions in private arrangements, a tradition of the rule of law in organized society is violated. One purpose of the rule of law is to require that the use of coercion be controlled by the State [citation]. In a highly developed commercial and economic society the use of private force is not the danger, but the uncontrolled use of coercive economic sanctions in private arrangements." . . .

Note, even in Garrity (supra, at 359), the Court explicitly recognized that: "In a highly developed commercial and economic society the use of private force is not the danger, but the uncontrolled use of coercive economic sanctions in private arrangements."

That is my precise concern with the present rule. It appears that the present state of affairs, at least in the securities field, where consent to arbitration of disputes is now a sine qua non before the average citizen can open an account at any brokerage, has reversed the application of these principles enunciated by the Court of Appeals. Before the United States Supreme Court decided that an arbitration agreement in an investor-broker contract was binding on the investor (see, Shearson/American Express v McMahon, 482 US 220), the investor could proceed in arbitration and waive any claim to punitive damages or bring suit in a judicial forum where such a claim would be cognizable. Since McMahon, this option has been largely foreclosed. The average investor would be hard put to find a brokerage that would accept his/her business without a prior arbitration agreement. Accordingly, arbitration has now become "a trap for the unwary" investor. Under the present state of affairs, the danger represented in "the uncontrolled use of coercive economic sanctions in private arrangements" (supra, at 359) no longer refers to the ability of an arbitrator to

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Still, arbitration is not of itself perceived as unfair to investors—so long as the premise of Shearson v. McMahon that no substantive rights are sacrificed in arbitration is satisfied, and so long as customers are not later surprised by "waivers" that appear nowhere in the preprinted arbitration agreements they are obligated to execute. But when those pillars fall down, so does the system of arbitration and investor protection they support. The proper solution is not to require every prospective investor to have an expensive out-of-state lawyer at hand, ready to scour out-of-state caselaw to figure out what the investor is agreeing to—or, in the alternative, expect that investors must suffer unstated "hidden traps" as the price they must pay for trying to stash away a few dollars for their retirement.

Permitting such a system of "hidden traps" also encourages serious overreaching by brokerage houses. In a case similar to this one, the brokerage house strenuously argued that "the **sole reason** for incorporating a New York law provision was to preclude punitive damages awards." J. Alexander Securities, Inc. v. Mendez, 17 Cal.App.4th 1083, 1093 n.9, 21 Cal.Rptr.2d 826, 832 n.9 (1993) (emphasis added), cert. denied, ___ U.S. ___, 114 S.Ct. 2182 (U.S. June 6, 1994). Since the brokerage house knew it was trying to effect a waiver, it could have just put plain language in its preprinted agreement: "No punitive damage awards are permitted in an arbitration arising out of the customer's

[6](...continued)

impose punitive damages, but the inability of the investor to recover for real, and in some cases, glaring abuses.

In re Arbitration Between Dreyfus Service Corp. and Kent, 183 A.D.2d 446, 448, 584 N.Y.S.2d 483, 484-85 (1992) (Asch, J., concurring).

accounts." Instead, the brokerage house chose the "hidden trap" method, by burying the attempted waiver within a choice-of-law provision. Id., 17 Cal.App.4th at 1093 n.9, 21 Cal.Rptr.2d at 832 n.9. Federal courts need not and should not enforce the Federal Arbitration Act in a way that tolerates and encourages such intentional overreaching, especially given the much broader consequences discussed herein.

There are further special concerns with preprinted brokerage house arbitration agreements. Such agreements are often valueless to customers, because even if there is no written agreement, the NASD and major stock exchanges all have provisions requiring member firms and associated persons to arbitrate customer disputes if the customer so elects. NASD Code of Arbitration, Sec. 12(a); New York Stock Exchange, Const. Art. XI and Rule 600; American Stock Exchange Const., Art. VIII, sec. 1.[7] In other words, without the arbitration agreement, the customer would still have the same right to arbitrate with a choice of arbitral tribunals.

Thus, often it is only the brokerage house that gains from a preprinted arbitration agreement. That would have been true in the Mastrobuonos' case as well, since Shearson is a member of all major exchanges and the NASD, and petitioners could have demanded arbitration before any of those bodies with or without an arbitration agreement.

Perhaps such a one-sided "agreement" is now thought to be the price a person must pay for putting money somewhere other than in a bank. But that does not mean a

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[7] The rules of the major exchanges are similar to the NASD rules and serve the same functions in arbitration. Dean Witter Reynolds, Inc. v. McCoy, 995 F.2d 649, 651 (6th Cir. 1993).

federal court should go beyond the agreement to arbitrate, and read into the customer's agreement a waiver of substantial rights that is not clearly and specifically spelled out therein.

In fact, quite the opposite is true, even without reference to the fact that the purported "waiver" is not based on any language in the contract. Under the principles of D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 187 (1972), a contractual waiver should not be enforced if it is a contract of adhesion, there is great disparity in the parties' respective bargaining power, and there is no consideration for the waiver. Accord L.K. Comstock & Co. v. New York Convention Center Dev't Corp., 179 A.D.2d 322, 329, 584 N.Y.S.2d 472, 478 (1992).

Those are exactly the facts of this case. While absence of consideration for a contractual waiver may be unusual, it is the situation here, because respondents' arbitration clause—the vehicle by which respondents are claiming a waiver of the right to punitive damages—gained petitioners nothing they did not have anyway under the NASD, New York Stock Exchange, and American Stock Exchange rules. As a result, the sought-after waiver of the right to punitive damages stemming directly from the arbitration clause in the Customer's Agreement should be unenforceable under an Overmyer analysis as well.

3. Conclusion To Part II(B)

All of these principles are especially applicable in a federal court. When a federal court is asked to interpret the Federal Arbitration Act, it must apply federal common law, since 9 U.S.C. § 2 "create[s] a body of substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." Moses H. Cone Memorial Hospital

v. Mercury Construction Corp., 460 U.S. 1, 25 (1983). And under federal law, a person is not held to have waived a substantive right unless (s)he knows (s)he is doing so.

This law should govern any invocation of the Federal Arbitration Act as well. The claimed "waiver" should be held not to exist, and should not be enforced by the federal courts.

If any doubts remained, they should be resolved in favor of the arbitrators' award. Indeed, it is arguable that the award should be respected now, and the District Court did not have subject matter jurisdiction to vacate the punitive damages portion. Once a dispute is held arbitrable, questions of procedure and law are for the arbitrators, especially under broad arbitration provisions such as section 12 of the NASD Code of Arbitration. Any ambiguity is resolved in favor of arbitration. Volt Information Sciences, Inc. v. Board of Trustees of Stanford University, 489 U.S. 468, 485-86 (1989). Here, the arbitrators considered respondents' claims, and ruled that punitive damages were awardable. Even if that were legally erroneous, legal error is not a ground in 9 U.S.C. § 10 for vacating an arbitration award.

In any event, based on the principles in this section, petitioners should not be held to have waived their right to punitive damages based on the choice-of-law provision in the Customer's Agreement.

CONCLUSION

For these reasons, as well as those set forth by the petitioners, AALP joins the petitioners in asking that the judgment of the Court of Appeals be reversed.

Dated this 14th day of November, 1994.

Respectfully submitted,

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